DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 07-0080
Income Tax
For The Tax Years 2002-2004

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ISSUES

I. Adjusted Gross Income Tax—Inclusion of Corporations in Combined Return.

Authority: IC § 6-3-2-2(l), IC § 6-3-2-2(m), IC § 6-3-2-2(p), *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 103 S.Ct. 2933 (1983); *ASARCO, Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 102 S.Ct. 3103 (1982).

Taxpayer protests the Department's decision to require filing a combined return.

II. Tax Administration—Corporate Income Audit Computation.

Authority: IC § 6-8.1-5-1(c).

Taxpayer protests the Department's computation of corporate tax liabilities.

III. Tax Administration—Ten-Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer seeks abatement of the ten-percent negligence penalty.

STATEMENT OF FACTS

The taxpayer operates a chain of restaurants throughout the United States, including Indiana. The taxpayer owns three corporations formed and located in Indiana for the express purpose of operating the restaurants located in Indiana (Indiana Corporations). The Indiana Corporations are owned by a finance corporation (Finance Corporation), which is in turn owned by a parent corporation for all taxpayer's operations during the audit period (Parent Corporation). Each of the Indiana Corporations filed Indiana returns for the 2002, 2003, and 2004 tax years. However, the taxpayer has never filed income tax returns in Indiana. The Indiana Department of Revenue ("Department") conducted an audit of the taxpayer for the respective tax periods. As a result of the audit, the Department determined that the relationship between the various corporations indicated that income distortion would result if the taxpayer did not file a combined return in Indiana. Based on the audit and determination, the Department assessed income tax for the audited years. The taxpayer protested the Department's determination and assessments, and a hearing was held. This Letter of Findings results.

I. Adjusted Gross Income Tax—Inclusion of Corporations in Combined Return.

DISCUSSION

The taxpayer protests the Department's determination that the taxpayer should have filed a combined return based upon the taxpayer's relationship with the Indiana Corporations, the Finance Corporation, and the Parent Corporation; and those corporations' economic activity within, or connection to, Indiana. The taxpayer asserts that the Indiana Corporations operate exclusively in Indiana and maintain their own set of financial records. These financial records reflect the entire operation of the Indiana Corporations' respective taxpayers in Indiana. The taxpayer summarily asserts that the operations in Indiana represent a discrete financial operating unit that is not affiliated with any of the other operations of the Parent Corporation.

Taxpayer further asserts that the Finance Corporation provides financing for the restaurants, including those operated by the Indiana Corporations. Under a written revolving credit agreement, the Finance Corporation provides a continuing loan to each of the Indiana Corporations.

The Parent Corporation supplies certain services and the right to use trademarks and other intellectual property owned by the Parent Corporation to the various operating entities, including the Indiana Corporations. The Parent Corporation licenses the use of the trademarks, "trade dress," and other intellectual property under a written license agreement with the Indiana Corporations, in exchange for a royalty payment.

The Parent Corporation has also entered into a written agreement with the Indiana Corporations to provide legal, accounting, product development, payroll and benefits administration, and management recruitment and training to the Indiana Corporations. This Management Services and System Guarantee Agreement also covers the Indiana Corporations' use of the Parent Corporation's operating system. Each of the Indiana Corporations pays the Parent Corporation actual cost plus a percentage of sales in exchange for Parent Corporation's provision of these services and system.

The Parent Corporation has also entered into a written Master Purchasing Agreement with each of the Indiana Corporations. Under this agreement, the Parent Corporation negotiates nationwide purchasing agreements for various food items. In exchange for these services, the Indiana Corporations pay a fee equal to a percentage of the cost of the items supplied under the particular supply contract.

The Parent Corporation has also entered into a written National, District, and Local Advertising Agreement with each of the Indiana Corporations. Under this agreement the Parent Corporation agrees to promote and enhance all restaurants within and under the Taxpayer's business umbrella, including those operated by the Indiana Corporations. In exchange for these services, the Parent Corporation receives a reimbursement of all reasonable expenses plus a percentage of sales.

Taxpayer admits in its protest that the Indiana Corporations, Finance Corporation, and Parent Corporation are owned by and part of a larger group of entities in Taxpayer's restaurant business. However, the taxpayer contends that the activities presented hereto for which there are intercompany charges are all being provided on an arms length basis and should not be the basis for combining the Indiana Corporations, Finance Corporation, and Parent Corporation into a unitary group for Indiana income tax filing purposes for the subject years. The taxpayer argued that the

operations in Indiana represent a discrete financial operating unit that is not integrated with any of the other operations of the Parent Corporation. Therefore, taxpayer should not have to file a combined income tax return that includes its non-Indiana subsidiaries.

Based upon the information provided by the taxpayer, the Department determined that the activities with, contributions to, and relationships between the Indiana Corporations, the Finance Corporation, the Parent Corporation, and the Taxpayer represent varying interests and business endeavors directly associated with the taxpayer's global business structure. Due to the substantial inter-corporation activities between the members of this group of corporations, and to fairly reflect the income earned from Indiana sources, the Department required the taxpayer to file on the unitary basis, and made tax liability assessments on that basis. The various agreements producing the income as described herein were negotiated and signed by board members of the Parent Corporation, which are also members of the corporations with which the respective agreements were signed. The Department's audit report shows that all of the related fees associated with these agreements were deducted from each of the Indiana Corporations' respective incomes to arrive at adjusted gross income for Indiana filing purposes.

Indiana law requires first a determination that the entities are operated as a unitary business. IC § 6-3-2-2(l) provides:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or **the department may require**, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> **(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (Emphasis added.)**

After it has been determined that the entities are unitary, the law requires that the income be reported in such a manner as to "fairly reflect" the Indiana income. IC § 6-3-2-2(m) provides:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The Department may also necessarily rely on IC § 6-3-2-2(p), which provides that: Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity . . . be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

The Supreme Court has considered the issue of a unitary relationship for adjusted gross income tax in several cases and with several analyses. The essential characteristic the Court requires for a unitary business is that the individual entities are functionally integrated in a common business. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 102 S.Ct. 3103 (1982). The Supreme Court found that unitary businesses that were functionally integrated shared many common characteristics. They had common ownership. They had centralized management with a corporate strategy including the various entities. The individual businesses were operated in such a manner as to further a common purpose.

According to documents and information supplied by the taxpayer, the taxpayer owned one hundred percent of the Parent Corporation, Indiana Corporations, and the Finance Corporation. The taxpayer has a board of directors for the Parent Corporation, with many of those members serving on subsidiary corporation boards of directors. All activities connected to the taxpayer's business, such as insurance, purchasing, taxes, and accounting are handled by related companies within the entity: financing by Finance Corporation; employee benefits by the Parent Corporation; purchasing by the Parent Corporation; advertising by the Parent Corporation. Management decisions were made to further the common goal of maintaining and expanding the taxpayer's restaurant network. Based upon this analysis, the Department can establish that the taxpayer owned the referenced Corporations; that taxpayer controlled the operations of each of the Corporations; and used each and all of the Corporations in forwarding taxpayer's common goal of creating and expanding its restaurant business.

The taxpayer did not provide adequate documentation to support its decision not to file income tax returns in Indiana, nor did taxpayer provide adequate documentation to sustain its burden of proving that the Parent Corporation, Indiana Corporations, and Finance Corporation were not part of the unitary business and should, therefore, not be included in a combined return.

Based upon the limited information provided, the Department asserts that each of the Corporations depend upon the unitary relationship established and maintained by the taxpayer. Combined filing is required if members of a unitary group are deriving income from Indiana sources. In this case, taxpayer, the Parent Corporation, the Indiana Corporations, and the Finance Corporation, as members of a unitary group are deriving income from Indiana sources. The restaurants owned by the Indiana Corporations pay a certain amount of the income they produce directly to the Parent Corporation because the Parent Corporation purportedly holds title to the intellectual property associated with, and used by, the Indiana restaurants; the restaurants pay an additional amount of income to the Parent Corporation for use of the Parent Corporation's operating system. In prior Letters of Findings, the Department has concluded that royalties paid to a subsidiary under similar circumstances establishes an Indiana nexus because licensing the royalty subsidiary's intellectual property to Indiana franchisees produced royalty income subject to the Indiana corporate income tax. To both effectuate an equitable allocation and apportionment of the taxpayer's income and fairly reflect their Indiana adjusted gross income, the taxpayer, Parent Corporation, Indiana Corporations, and Finance Corporation must be combined as a unitary business, as provided by the various subsections of IC 6-3-2-2.

FINDING

The taxpayer's protest is denied.

II. Tax Administration—Corporate Income Audit Computation.

DISCUSSION

Taxpayer argues that, should its protest regarding the Department's determination that the taxpayer, Parent Corporation, Indiana Corporations, and Finance Corporation be combined as a unitary business be denied, the Department's figures and computations should be re-calculated, or at least clarified.

Department assessments are presumed to be correct. The taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c). This taxpayer first argues that the Department's audit report did not include a tax computation schedule, making the taxpayer's review for accuracy difficult. Second, the taxpayer asserts that the sales apportionment factor calculated by the Department considered only gross sales and did not include other income items. Third, the taxpayer asserts that the Parent Corporation owned wholly owned partnerships and that the partnership apportionment factors were not included in the report. Because the Department included the partnership income in the Department's combined return assessment, the Department should also include these partnership apportionment factors. Fourthly, the taxpayer argues that the Department's interest computations are incorrect, with no credit given for the 2003 tax overpayment.

Based upon the information provided by the taxpayer in its protest and during the hearing, coupled with a preliminary analysis of taxpayer's arguments, the taxpayer has sustained its burden.

FINDING

Subject to the Department's supplemental audit, the taxpayer is sustained.

III. Tax Administration—Ten-Percent Negligence Penalty.

DISCUSSION

The Taxpayer protests the imposition of the ten-percent negligence penalty pursuant to IC § 6-8.1-10-2.1. The Taxpayer argued that the Department should waive the ten-percent negligence penalty because the Taxpayer claims it was audited in 1996 and 1997 based upon the same set of facts as presented in its protest addressed herein, and that the Department did not find that a combined return should be filed in Indiana. The Taxpayer operated on the assumption that it could rely on the 1996 and 1997 audits for its subsequent 2002, 2003, and 2004 filing methodology.

45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence

> would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations**. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence**. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer. (**Emphasis added.**)

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Based upon the facts and explanation provided in the Taxpayer's protest and, pursuant to 45 IAC 15-11-2(c), the Department deems taxpayer's reliance on a previous audit as reasonable cause for its failure to timely remit income tax liabilities resulting from the Department's audit. Therefore, the ten-percent negligence penalty should be waived.

FINDING

The Taxpayer's protest to the imposition of the ten-percent negligence penalty is sustained.

LM/BK/DK –November 8, 2007